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SUBJECT: PORTUGAL: FINANCIAL CRISIS CAUSES STRAIN BUT NO IMPENDING DOOM

SUMMARY
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¶1. Portuguese banks and financial institutions have adequate capital to ensure solvency and limited exposure to the devalued assets plaguing larger financial institutions elsewhere in Europe, yet the Portuguese public is nervous about recent difficulties of large U.S. and European institutions and the stock market's 9.86 percent decline on October 6 was the largest in its 15-year history. The GOP response is to focus on increased regulation and guarantees to strengthen confidence in the financial sector. However, the tighter global credit market is slowing economic activity and threatens to stall a Portuguese economy that had been growing slowly but steadily since 2003. End summary.

LOW EXPOSURE, LOW RISK, BUT STOCKS REFLECT LOW CONFIDENCE
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¶2. Although continuing to lag behind average EU rates for growth and competitiveness, the Portuguese economy is weathering the current financial crisis well. Portuguese financial institutions are not heavily invested in mortgage-backed securities or faltering financial institutions - while over fifty Portuguese funds have some level of exposure, the total value of these investments is just over 87 million euros (USD 120 million), and there are adequate capital reserves on hand to ensure solvency.

¶3. Despite the relative security of Portuguese banks, the public is increasingly concerned about the highly-publicized failures and bailouts of large U.S. and European financial institutions. The financial sector and the Ministry of Finance have responded with an extensive media campaign underscoring the low risk of failure of Portuguese institutions and publicizing existing protections for depositors, such as the Guaranteed Deposit Fund. This Fund, participation in which is mandatory for all deposit institutions, is similar to FDIC insurance and guarantees deposits up to 25,000 euros (USD 34,500) per account. On October 6 Finance Minister Teixeira dos Santos said all Portuguese deposits will be guaranteed, but a new guaranteed deposit ceiling will be set after the European Commission makes its recommendation.

¶4. Declining public confidence in the world economy and in governments' ability to control the crisis is also reflected in stocks here, which on October 6 plunged 9.86 percent, the largest one-day loss in this market's 15-year history. This decline in Portugal's principal index exceeded losses suffered the same day by stock markets in the U.S. and EU countries much more heavily invested in mortgage-backed securities.

STRENGTHENING REGULATION, BUT TIGHTER CREDIT A SQUEEZE
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¶5. GOP response to the crisis has focused on strengthening regulation and oversight in the financial sector. Finance Minister Teixeira dos Santos is advocating increased

reporting of exposure to questionable assets and overall financial health, shareholder endorsement of executive compensation, and higher penalties for financial malfeasance.

¶6. However, Portugal is not immune to the impact of the tightening global credit market. For the April-June 2008 quarter, new mortgage applications declined almost sixteen percent from the same period last year, and new mortgages issued for June 2008 were the fewest since 2004. Existing homeowners are also feeling the pinch because most mortgages here have variable interest rates. Continuing pressure in credit markets could stall the slow but steady Portuguese economic upswing since 2003, and this concern is reflected in the International Monetary Fund's downward revision of projected growth for Portugal to 0.7 percent for 2008 and 0.6 percent for 2009.

COMMENT
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¶7. Portugal's conservatism has served the country well in this crisis, but the country cannot avoid the impacts of the global credit squeeze and eroding public confidence. We expect economic growth to slow here, but we do not foresee the spectacular institutional meltdowns seen in other countries. End comment.
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